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# DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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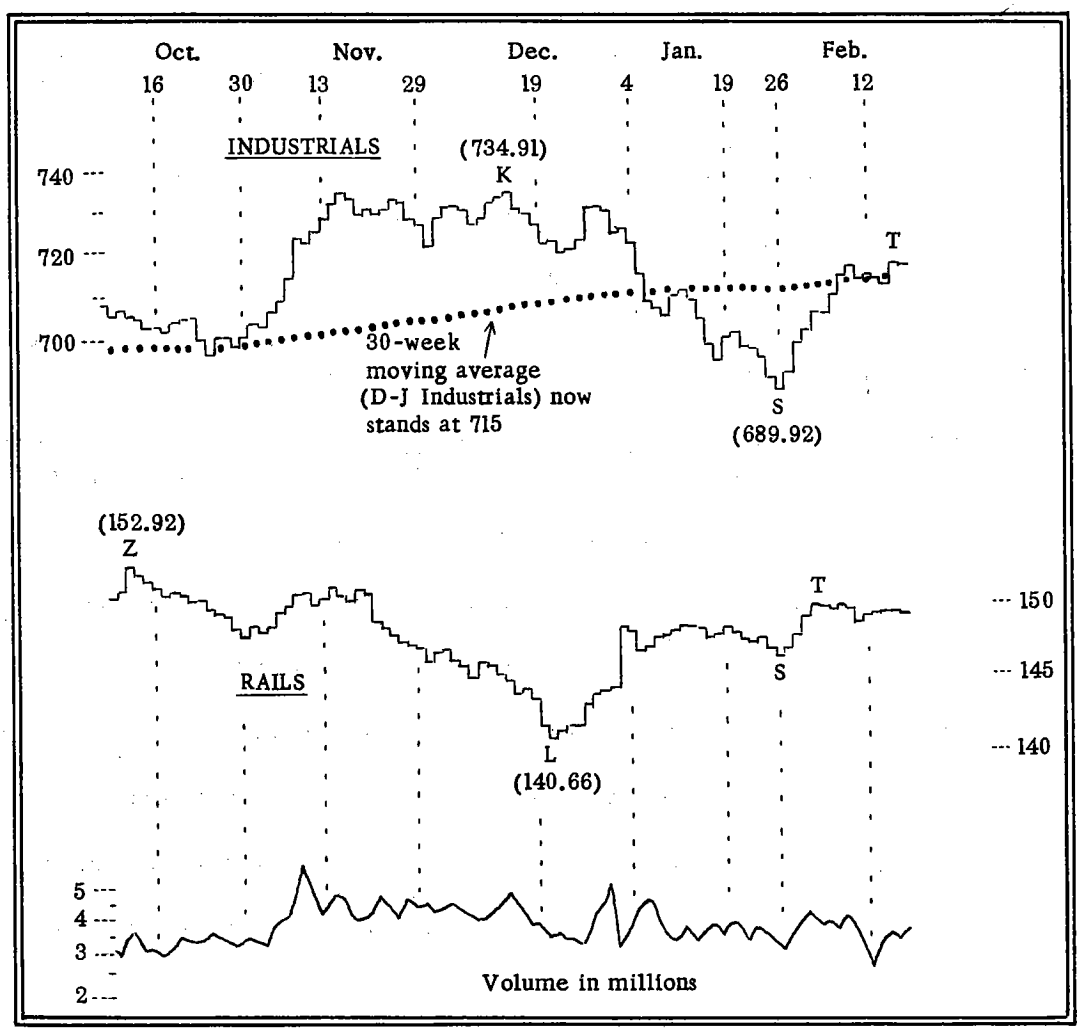
THE MARKET The major advance which began in October, 1960, struck its first important ( Industrial) peak in May, 1961 (705.96). Following the May peak, two further attempts were made by Industrials to add appreciable "yardage" to the 1960-61 rise. The first effort terminated in September at 725.53; the second ended in December at 734.91.

Following each of these peaks (May, September, December), the Industrial Average staged a retreat back to the 680-90 area. The long history of the Averages shows that when the market has lost its buying enthusiasm following an extended advance, that enthusiasm is seldom "regenerated" until a substantial decline has succeeded in producing a phenomenon which (for want of a better word) we call an "oversold condition". Actually, this means that those traders and investors who sold at the peaks will generally not be lured back into the market until prices have dropped to levels which can again be considered attractive for new purchases.

Since neither the July low (679.30) nor the September low (691.86) produced the expected fully "oversold" condition, I was somewhat suspicious of the recent January low of 689.92 (S). Moreover, I stated that it was my opinion that a further decline (which might take Industrials under their July - 679.30 - low) would have the effect of producing a truly sold-out market -- i.e., a market which had declined sufficiently to attract a substantial following.

From the recent January low at S (689.92), Industrials have rallied 28 points to T. Over the same period (S to T), Rails advanced less than 4 points; in so doing, the carriers failed by 3 points to better their previous peak at Z (152.92). An Industrial retreat retracing (correcting) 1/3 to 1/2 of the S-T rise would now be perfectly normal. However, it is my feeling that an attempt to extend the current advance (from above S) will lack the technical strength which would have otherwise resulted from a major oversold condition.

Two sets of observations are worth making at this time: On the S-T rally, neither volume nor new highs have (so far) expanded to impressive proportions. The high volume day of the advance appeared in the middle of the rally (February 1 - 4.2 million shares). After February 1 volume trailed off. Furthermore, as of February 15 the five-day average of new highs totaled 36, an



unexciting figure considering that new highs averaged 97 on November 14 (at which time the Industrial Average was only 17 points above the current area). While the technical statistics are always subject to dramatic improvement, we must work with what we have, and so far, the S-T rally must be catagorized as lacking power.

On the other hand, Barron's Low-Priced Stock Index rose, on the week ending February 9, to 231, its highest closing since the all-time peak of 250 set in March, 1959. This hints of a potential rise in speculative sentiment, a factor which has been absent in the market for many months.

CONCLUSION: The primary trend is bullish. The secondary trend, still obscure, will also be pointing up if Industrials rise above K (734.91) and Rails rise above Z (152.92). A hurdling of those two points would obviously also reconfirm the primary bull trend.

NOTE Letter 170 contained an error. Under "Conclusion" on Page 1, it should read: "The primary trend remains bullish. The secondary trend has been obscure....."

TRADING RANGE The market has been (and still is) caught in the grip of an extended trading range. For the past eleven months the Averages have held their "verdict" in abeyance, nor did last week's action do anything to alter the situation. It should be remembered that the function of the market is neither to review history nor to adjust to today's corporate reports -- it is to discount the future. I have frequently remarked that the Averages seem to be wrestling with problems which they cannot, or have not, been able to resolve. The exact nature of the market's "problems" are seldom fully understood at the time, if, indeed, they are ever understood. Certainly such sundry items as the adverse balance of payments, the gold outflow, higher interest rates, increased manufacturers' costs have received enough publicity in the nation's press. Perhaps investors have been numbed into immobility by our Administration's strange efforts at arithmetic (of which the new "budget" is the latest example).

A most interesting interpretation of the current situation has been provided by James Hughes of New York, a man who is particularly conversant with the stock market in terms of "breadth" (the advance-decline ratio), the Averages and the banking figures (see Letter 170). Hughes has noted that since the early part of the Twentieth Century, the following sequence has always held sway: (1) During bull markets the investment accounts of the member (Federal Reserve) banks hit a peak and turn down. (2) The advance-decline ratio records a later peak and turns down. (3) The Industrial Average records a final bull market peak after bank investments and breadth have recorded their own peaks, and thus the bull market ends.

Recently, Hughes writes that the Federal Reserve authorities have now "... permitted an expansion in the investment accounts of the member banks to continue beyond a peak in the breadth index (beyond the May peak on the advance-decline ratio). Never before during the forty years from 1919 to 1959 has this been allowed to happen. Without exception, highs in breadth have been preceded by major tops in (bank) investments."

Moreover, notes Hughes: "... the investment account increased more than $12 billion since April, 1961. This is the largest increase ever recorded in the exciting fluctuations of bank investments".

All this means that the stock market has not (so far) been responding to what must be considered new heights in generosity on the part of the Federal Reserve. For with bank investments having risen to a January 31, 1962 peak, it is notable that eight months have elapsed since the May peak on the advance-decline ratio. It seems to this writer that it is taking more and more "juice" to budge the economy, and each economic rise (since 1949) is less impressive.

I put these observations to subscribers not because I want to add to their worries, but simply to illustrate the difficulty of the present situation. A "normal" market will usually provide investors with plenty of "food for thought"; a market (such as this one) which deals in unprecedented relationships, deserves the utmost from both the trader and the investor.

The great profits in the market have usually been made by those who assume a position through the better part of an extended primary swing. During trading ranges such as the one we have been in since March of last year, market profits are obviously hard to come by (if this is any consolation to those who show little or nothing for their efforts over the last year).

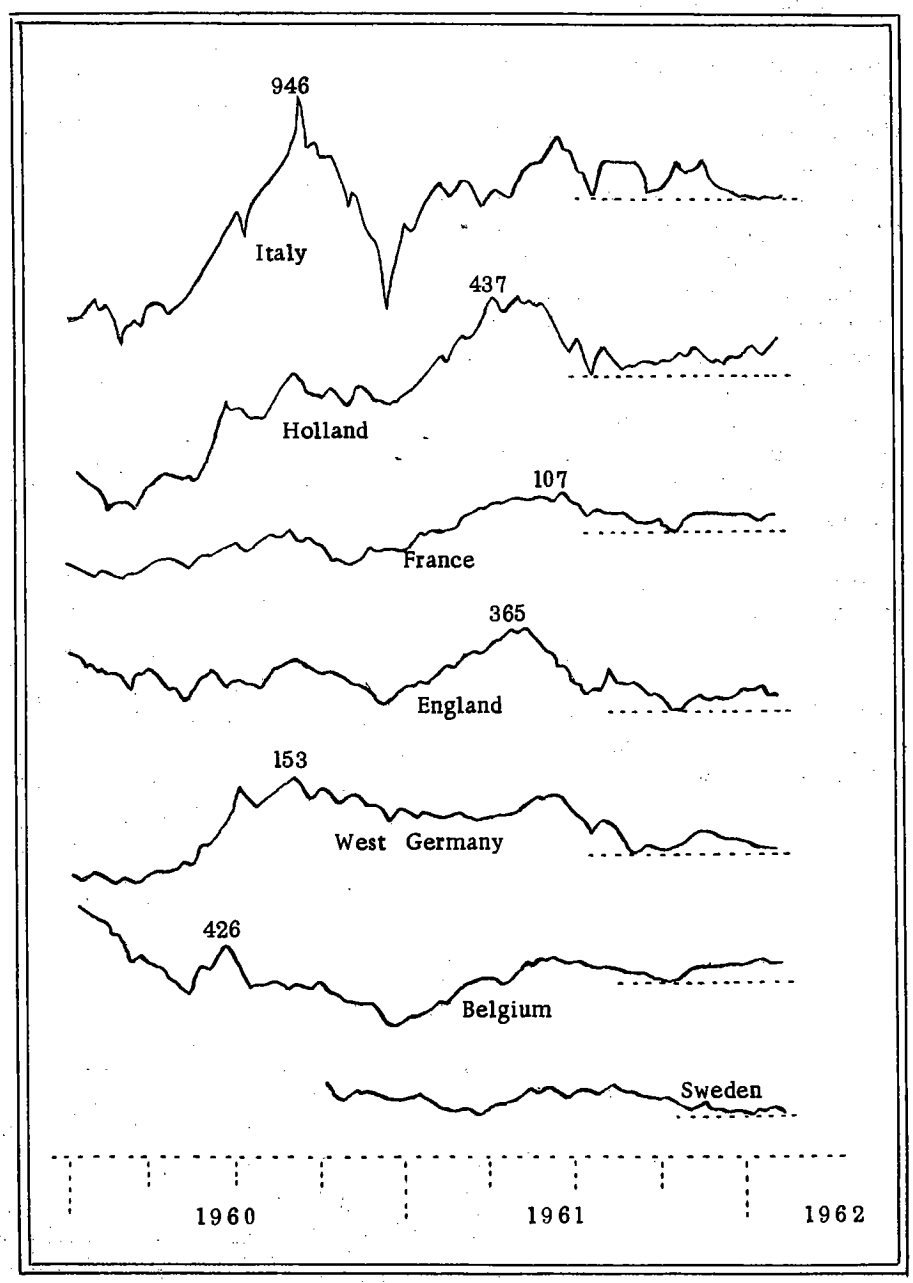
FOREIGN MARKETS Lest American investors think that they possess a monopoly on difficult markets, I call readers' attention to the chart on page 3 which shows the profiles of seven foreign stock averages. As this study is a periodic feature of these Letters, I need not go into details regarding the primary trend except to say that in the history of markets it has been shown that true

primary movements are always international in scope. Thus, for instance, neither the French nor the Belgian markets, despite the most disturbing developments in those countries, were seen to collapse over the last year or two. Certainly, in a primary bear market the Belgian-African and the French-Algerian troubles would have been sufficient to play complete havoc with the stock markets of those countries. A rising tide, like the tide of the ocean, sweeps all before it; at such times the broken hulks of half-sunken ships may be expected to rise with the sleekest of ocean liners.

Of particular interest at this time is the fact that all seven of the foreign markets pictured here are caught up in the same sort of trading range as that which currently engulfs the New York Stock Exchange. It is as if investors throughout the Free World had suddenly paused to await the next clear impulse. The dotted lines on the chart are drawn through the lows of the recent sideways movements, and it can be seen that in no instance has any foreign market moved far from its own base. How long can all this last? An ancient Chinese philosopher (in what must have been a reference to sideways market movements) was heard to say: "This too shall pass".

STOCKS Of 56 "key" stocks which are watched at this office, 24 are now above their 10-week moving average. This is a slight improvement of 2 since the last Letter.

A number of subscribers have written to ask the method by which I select stocks. In general, group relative strength is scrutinized. When a particular group shows evidence of developing strength, stocks within that group are then "sifted". If a particular stock shows up as stronger than the group, and if that stock is reasonably near (1) a base, or (2) a "breakout" point from a recognizable accumulation formation, that stock is then suggested in these Letters.




I have been asked whether I consider fundamental information in arriving at stock selections. In most cases, the answer is no. This does not mean that I am "against" true fundamental information; it simply means that I have not been successful in gathering the sort of fundamentals that count.

There are other problems connected with the use of fundamentals. (1) Assuming your information is correct, you cannot know for certain whether the market has already discounted that information (never underestimate the discounting power of the market). (2) Assuming your information is correct, you have the critical problem of timing. In other words, when (if ever) will the market decide to act on the fundamentals?

To give an example, a friend of mine knew the problems of Texas Instruments intimately, shorted the stock at 135 to 150. The stock rose to 256 before the market decided that something was wrong. Subsequently, TXN dropped below 100. My friend's information was dead right, his timing was dead wrong. As Hamilton once put it, many traders have gone broke "by being right too soon".

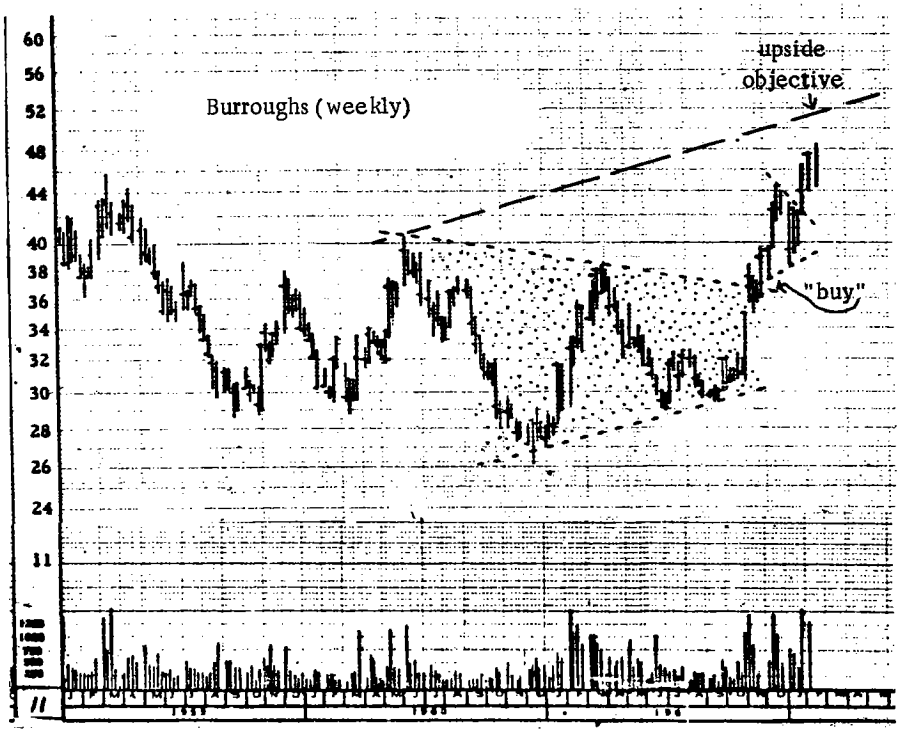
Personally, I am apt to use the fundamentals in reverse. This in Letter 161 I recommended the purchase of Standard of Jersey on an upside

breakout. The news about the oils at the time was dreadful; every newspaper and magazine was writing about the problems of "Russian dumping" and the "oil price wars". In the face of this, the leading oil equity turned bullish. The market seemed to be acting on something which was diametrically opposed to what the analysts were predicting. Jersey subsequently rose from 46 3/4 to 56.

Burroughs was originally recommended in Letter 162 at a price of 36; it was recommended again in Letter 164 at 38. In Letter 165 I drew attention to the upside "target" on BGH and again suggested purchases. From correspondence received, I know it is now the most widely held issue among my subscribers.

The great triangle (dotted area) on BGH produced a "buy" signal at 36. A second smaller triangle was formed, and this too was broken on the upside. Letter 165 stated that the minimum upside projection from a triangle breakout could be measured by an ascending line (dashed line on chart) drawn parellel to the bottom line of the triangle. At last week's closing of 48 1/4, BGH had appreciated 33% since the original recommendation, and it had risen to within about 4 points of its minimum upside target.

Since it does not pay to be greedy, I recmmend that 1/3 to 1/2 of the orignal purchases of BGH be sold between the current price and 52. If BGH breaks substantially above 52, the remainder of the shares held could be in for another pleasant "ride".




The Rail Equipment group is showing up as one of the stronger groups on "the Board". Westinghouse Air Brake was suggested last week, and I have included a chart of Baldwin Lima in this Letter. The stock has formed a large "rounding bottom" and volume implications are correct for such a formation. Try to buy the stock on a dip to the 15 1/2 to 16 1/2 area. Rounding bottoms such as this one often provide one final decline before moving up in earnest. Baldwin is classed as a typical low-priced stock, and the very recent strength in the Low-Priced Stock Index could also help an issue such as Baldwin.

Written, Monday February 19, 11 A.M. New York Time.

Charts of Baldwin and Burroughs courtesy of Traders Research, P.O. 2644, St. Louis 16, Mo.